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TO RUEHC/SECSTATE WASHDC 4519
INFO RUCPDOG/USDOC WASHDC
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RUEHNE/AMEMBASSY NEW DELHI 0080
RUEHKA/AMEMBASSY DHAKA 9511
RUEHIL/AMEMBASSY ISLAMABAD 6416
RUEHKT/AMEMBASSY KATHMANDU 4467
RUEHKP/AMCONSUL KARACHI 2039
RUEHCG/AMCONSUL CHENNAI 6969
RUEHLMC/MILLENNIUM CHALLENGE CORP

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SIPDIS

STATE FOR SCA/INS AND EB/IFD/OMA;

COMMERCE FOR E YESIN

TREASURY FOR S CHUN

MCC FOR D NASSIRY AND E BURKE

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E.O 12958: N/A

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SUBJECT: SRI LANKAN RUPEE SLIDES AGAINST DOLLAR

¶1. Summary: The Sri Lankan depreciated markedly in the past three weeks and touched an all-time low of Rs 107.40 to the dollar on October 17. However, after the Central Bank commented against excessive speculation on the same day, the slide did not continue. End Summary.

¶2. The Sri Lankan rupee slid by about 4 percent during the past three weeks touching an all time low of Rs 107.40 to the dollar on October 17. The rupee started its steep depreciation after the Central Bank withdrew from intervening in the market since early October. Previously, the Central Bank was intervening in the market to contain import prices (including oil) and maintain confidence in the market. According to a senior Central Bank official, the Bank has sold about USD 400 million since January 2006 to defend the rupee.

¶3. As the rupee's slide continued early this week and some banks booked dollars heavily, the Central Bank issued a statement warning against excessive speculation. The Central Bank said that certain players are transacting at levels well beyond normal import/export requirements. It added that excessive speculation is unwarranted as foreign exchange reserves were healthy and likely to increase in the coming months. According to the Central Bank, official foreign reserves stand at \$2.4 billion - sufficient to finance about 3 months of imports. Following this statement the rupee gained, and closed around Rs 106 on October 19.

¶4. The Central Bank expects the rupee to continue trading around current levels for the short term, but to gradually depreciate. Commercial banking sources allege the Central Bank is regularly resorting to moral suasion to discourage banks from speculating and trading excessively in the market. According to them, the government could introduce other regulations to control the foreign exchange market, such as placing new limits on overnight positions and forward currency trades, if speculative activity continues.

¶5. Comment: Due to inflation running over 15 percent, a widening trade deficit, as well as the recent strengthening of the dollar in the world markets, the rupee's slide was anticipated. The depreciation has provided a much needed adjustment to the currency, and will help Sri Lankan exports to remain competitive. Sri Lanka's

trade deficit has expanded by over 50 percent in the first eight months of the year to USD 2.4 billion from USD1.5 billion in 2005.
End Comment.

BLAKE